APPENDICES

APPENDIX A

Opinion of Court of Appeals

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
SEPTEMBER TERM, 1967—APRIL SESSION, 1968
No. 16580

THE FRANKLIN LIFE INSURANCE COMPANY,

Plaintiff-Appellee,

—v.—

UNITED STATES OF AMERICA,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

July 11, 1968

Before CASTLE, *Chief Judge,* HASTINGS, *Circuit Judge,* and KNOCH, *Senior Circuit Judge.*

CASTLE, *Chief Judge.* The United States of America, defendant-appellant, prosecutes this appeal from a judgment in the amount of $1,303,011.88 entered against it in

favor of The Franklin Life Insurance Company,[1] plaintiff-appellee. The judgment represents a refund of amounts assessed against the taxpayer as income tax deficiencies, and interest thereon, for the calendar years 1958 through 1962. The taxpayer had paid the deficiencies and brought suit in the District Court for refund.

The issues presented on appeal involve the construction and application of the Life Insurance Company Income Tax Act of 1959, Sections 801 through 820 of the Internal Revenue Code of 1954, as amended (26 U.S.C.A., §801-§820). The Act establishes a statutory framework directed to the measurement of life insurance company total income on an annual basis for use in the application of an annual tax. It utilizes a series of separate computations in the determination of the final tax.[2] A tax at corporation rates is levied on "life insurance company annual income". As it applies in the instant case, a third factor having no application to the taxpayer for the years here involved, such annual income is defined in Section 802(b) to be the sum of:

> "(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809), [plus]
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> (2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, ..."

In addition to defining various of the items to be used in the computations required in the ascertainment of in-

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[1] Hereinafter referred to as "taxpayer".

[2] For a short description of the Act, see *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233.

vestment income and gain from operations, the Act (Section 818(a)) provides:

> "All computations entering into the determination of the taxes imposed by this part shall be made—
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> (1) under an accrual method of accounting, or
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> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

The first two specific issues presented on appeal involve basically the same problem—that is, the way in which deferred and uncollected portions of gross annual premiums[3] are to be handled in the computations. The Com-

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[3] The gross annual premium under a life insurance policy is the consideration paid by the insured for coverage for a policy year, which is twelve-months from the date of issuance of the policy, and each twelve-month period subsequent to its anniversary date. Deferred and uncollected premiums are portions of the annual premiums on policies in force at the end of the taxable year on which collection has not been made. This non-collection is attributable either to the fact that (1) policy premium installments are spread over the policy year and a portion of the gross annual premium will not be collected until the following taxable year, or (2) the premium is due but not yet paid because of the thirty-one day grace period provided in the policies.

In addition, the gross annual premium (and any deferred or uncollected portion thereof) is composed of two elements. The net valuation portion, referred to as the net valuation premium, is an

missioner held: (1) that taxpayer in computing gain from operations pursuant to Section 809 was not entitled to a deduction or offset for "increase in loading on deferred and uncollected premiums" and (2) that taxpayer was not entitled to exclude the loading on deferred and uncollected premiums from assets in the computation of investment income pursuant to Section 804, but was required to reflect the full gross premium in assets. The District Court concluded, to the contrary, that taxpayer was entitled to deduct or offset the item "increase in loading on deferred and uncollected premiums" in computing gain from operations, and was entitled to exclude the loading on deferred and uncollected premiums from assets for purposes of the Section 804 computation of investment income.

The other two specific issues involve the treatment of interest on loans to policyholders. The life insurance policies and annuity contracts issued by taxpayer, which have cash values, provide that a loan may be obtained on the sole security of the policy at any time that a cash value is available and while the policy is in force. Interest on policy loans is payable in advance at the time the loan is made to the end of the current policy year and annually thereafter on the policy anniversary date for the ensuing year. If interest on the policy loan is not paid when due, it is added to the principal of the existing loan and bears interest at the same rate. The Commissioner held that the full amount of the interest paid in

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amount, computed under legally required interest and mortality assumptions, which it is estimated will be required each policy year for reserves for payment of policy claims. The difference between gross annual premium and net valuation premium, referred to as loading, makes up the second portion. It represents agents' commissions, administrative expenses, etc.

advance must be included in investment income in the year of its receipt, and that the full amount of interest added to principal must be included in assets in the investment income computation in the year added. The District Court concluded that taxpayer need recognize as income only the portion of the interest received and deemed earned in the taxable year, and need recognize for asset purposes only the portion of interest added to principal deemed earned in the taxable year.

Examination of the District Court's findings and conclusions reveals that it rejected the Commissioner's holdings with respect to the treatment to be accorded to loading on deferred and uncollected premiums on the premise that the treatment of this item in the annual statements filed by taxpayer with the various state insurance departments reflects a method of accounting with respect to such item which must be given governing effect in the computation of the "gain from operations" and "investment income" factors of the tax formula contained in the Internal Revenue Code. In this connection the record discloses that the treatment accorded the loading on deferred and uncollected premiums under the method of accounting prescribed by the National Association of Insurance Commissioners (NAIC) for use in the preparation of the annual statement form it has designed to show the solvency status on a liquidation basis of life insurance companies permits the offsetting of increase in loading on deferred and uncollected premiums in the determination of company income and the exclusion of loading on deferred and uncollected premiums in the determination of company assets. The NAIC was organized in 1871 and is a national organization composed of the officials of the various states who are charged

with the supervision of life insurance companies and their operations. Soon after its organization, the NAIC adopted a uniform annual statement form and life insurance companies have filed their annual statements since that time on such forms in accordance with the instructions prepared by the NAIC for such purpose. The taxpayer was required by the laws of Illinois, the state of its incorporation, and of the other states in which it did business to complete and file the NAIC annual statement form and to comply with the instructions approved by the NAIC for use in that connection. The taxpayer did so with respect to its annual statements for the tax years here involved.

But it is our opinion that the District Court erred in giving overriding effect to the method of accounting utilized by the NAIC for annual statement purposes. Reliance upon the provisions of Section 818(a) quoted supra does not warrant the conclusion the court reached. The crucial question here is not whether the method of accounting prescribed by the NAIC in connection with the annual statement form it has designed to show solvency status is in its nature a form of accrual accounting or whether the adjustments permitted thereunder are required or appropriate for the purpose the annual statement form is to serve. Nor is it of import that Section 818(a) in prescribing that "computations" entering into the determination of the tax imposed shall be made under an accrual method of accounting provides that except for such restriction[4] computations shall be made in a

[4] The clause of Section 818(a) which permits use of a combination of accounting methods exclusive of a cash receipts and disbursements method, to the extent permitted by regulation prescribed by the Secretary or his delegate, has no application in the instant case.

manner consistent with that required for NAIC annual report purposes. The careful and detailed attention given by Congress throughout Sections 801 through 820 to definition of the particular items utilized as factors in the tax formula and in specifying and enumerating the permissible deductions and exclusions negates the existence of any intent on the part of Congress to relegate the substantive matter of offsetting or excluding loading on deferred and uncollected premiums, with its concomitant impact on the resulting tax, to the NAIC.

Section 809(c)(1) specifically requires the inclusion of "the gross amount of premiums" for the purpose of determining "gain from operations" as defined in Section 809(b)(1). Taxpayer concedes that the intent and purpose of the Act require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading). In our view that concession leaves no basis for further controversy. This is especially so in view of the fact that Congress has provided twelve specific deductions in Section 809 but makes no provision for an offset or deduction for "increase in loading". And, the burden is on the taxpayer to show the express statutory authority for a deduction claimed. *Equitable Life Insurance Co. of Iowa* v. *United States,* 8 Cir., 340 F. 2d 9.

Taxpayer seeks to justify the District Court's exclusion of loading on deferred and uncollected premiums from assets in the computation of "investment income" pursuant to Section 804 on the basis of taxpayer's obligations to policyholders, *i.e.,* reserves. But taxpayer in computing its reserves for tax purposes did so on the assumption that on each policy anniversary the full annual premium has been received. The very reason for showing deferred and uncollected premiums in full in assets is that this is

in accord with actual accrual accounting principles. Wightman, Life Insurance Statements and Accounts (1952), pp. 44-46. The assumption that the annual premium has been received in full is, of course, a fiction, since annual premiums on all policies have not been received as of the end of the taxable year; rather, a portion thereof remains deferred and uncollected. The use of the fiction results in a bigger reserve liability figure and consequently bigger reserve liability deductions and exclusions than if reserves were computed on the basis of only those premiums actually received. If the fictional assumption were not indulged and only those reserves were accrued as were attributable to paid up portions of annual premiums, then the problem from an accrual standpoint would be simpler. But, Congress, apparently cognizant of the assumption upon which taxpayer and other life insurance companies compute reserves for annual statement purposes because of state statutory requirements chose to recognize such assumption in the tax formula it prescribed and to base an accrual reporting requirement on that assumption. And, the application of accrual principles after that assumption has been made, will not permit of accrual of the entire annual reserve on one hand without incident accrual of the full annual premium. The District Court would permit the taxpayer to accrue a full year's liability without a corresponding accrual of the related year's asset in point of time. Such a result would attribute to Congress an intention that in the same statutory equations, exclusions and deductions attributable to reserves are to be based on the assumption that the annual premium is fully paid up and yet the amounts in the same equation from which these figures

are to be subtracted are to be determined on the assumption that the annual premium is not fully paid up. This is, in effect, saying that Congress, when it specified accrual accounting, must have meant one rule to apply to reserve deductions and exclusions and another different accrual rule to apply to determining the amount from which the former are to be subtracted. We perceive nothing from which intent to impose such a dual standard of tax accounting can be presumed.

That the NAIC is willing to allow an admittedly overstated reserve while at the same time allowing an accounting entry with respect to assets which, while compensating *numerically* for the overstatement, does not fully account for the related asset, is of no aid to the taxpayer here. The acceptance of such an adjustment as being in accord with conservative and stringent solvency requirements does not permit of the utilization of such an approach to alter or modify the substantive provisions of a tax formula concerned with the *proportionate* relationship between assets and reserves. The gearing of the tax statute to an annual reserve requires recognition of no less than the annual premium.

We conclude on the phases of the appeal concerning the District Court's resolution of the issues involving the treatment of deferred and uncollected portions of gross annual premiums that the District Court erred,[8] and

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[8] We are cognizant of, and have considered, the recent decision of the Tax Court in *Western National Life Insurance Company of Texas* v. *Commissioner* (Opinion dated May 13, 1968) in which it is held that the entire amount of deferred and uncollected premiums is to be excluded from the asset side of the formula. The Tax Court opines that "only resort to medieval metaphysics could translate the items in question [deferred and uncollected premiums] into 'assets' ". But see: *Jefferson Standard Life Insurance Co.* v. *United States*, M.D. No.Car., 272 F. Supp. 97 (1967).

we turn to consideration of the remaining issues related to the treatment of interest on loans to policyholders.

Under the express terms of taxpayer's policy loan agreements with borrowers interest is paid in advance at the time of the loan to the end of the current policy year and annually thereafter on the policy anniversary date for the ensuing year, and interest not paid when so due is added to the principal of the existing loan. As hereinbefore stated, the Commissioner held that the full amount of the interest paid in advance must be included in investment income in the year of its receipt, and that the full amount of interest added to principal must be included in assets in the investment income computation in the year added. The District Court concluded that taxpayer need recognize as income only the portion of the interest received and deemed earned in the taxable year, and need recognize for asset purposes only the portion of interest added to principal deemed earned in the taxable year. In this connection the record discloses, and the court found, that the whole or any part of the indebtedness arising from a policy loan may be repaid at any time; if repayment of a policy loan is made during the policy year, the exact amount of interest ratably earned by the taxpayer is retained by it and the residue is returned to the policyholder; if the policyholder should surrender his policy for the cash value then only the exact amount of prepaid interest ratably earned is retained by the taxpayer and the residue is returned to the policyholder; and if the policyholder should die then only the exact amount of prepaid interest ratably earned is retained by the taxpayer and the residue is paid to the beneficiary of the policy. Capitalized interest

added to principal is similarly retained or returned on the basis of whether it has been ratably earned. Taxpayer's books are kept on this basis. Interest on policy loans is taken into income or assets only as ratably earned. In view of the foregoing considerations the District Court reasoned that the Commissioner's treatment of the prepaid interest and the capitalized interest items constituted application of "a hybrid method of accounting . . . partially on an accrual method and partially upon a cash receipts and disbursements method in contravention of Sec. 818(a)(2) of the Internal Revenue Code of 1954 which enjoins the Commissioner from using the cash receipts and disbursements method for determining the taxable income of a life insurance company".

In support of the District Court's conclusion that taxpayer need recognize as income and assets only the portion of prepaid or capitalized interest which has been ratably earned during the taxable year the taxpayer points to the possibility that if the borrower elects to terminate the loan or dies taxpayer will be in the position of returning some of the interest paid to it, and argues that the money it receives must be *earned* before it is includable in its taxable income as an accrual basis taxpayer.

There is no question that taxpayer is an accrual basis taxpayer. Section 818(a) requires that it utilize an accrual method of accounting for the determination of its income tax. But, non-deferral of prepaid items is not foreign to permissible or required accrual accounting for income tax purposes. *Schlude* v. *Commissioner*, 372 U.S. 128; *American Automobile Association* v. *United States*, 367 U.S. 687, 695. Thus, as pointed out in *North American Oil* v. *Burnet*, 286 U.S. 417, 424:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

And, here the taxpayer receives the interest under a binding agreement with the borrower calling for its receipt and without restriction upon its use by the taxpayer. The money is "earned" in a context sufficient for full tax recognition in that taxpayer, when it receives the interest, is fully entitled to it under the express terms of the policy loan agreement. And taxpayer is free to use or invest the full sum in any way it sees fit. The taxpayer, for the purpose of its own bookkeeping, may choose to reflect the money so received only over the course of the policy year, but this does not negate the fact that the interest has been received without restriction as to its use.

Apart from any charismatic application of the "claim of right" concept referred to in *North American Oil, supra,* we are of the view that the underlying rationale of *Schlude* and *American Automobile Association* leaves the Commissioner free to reject the deferral of prepaid items where not to do so would not "clearly reflect income" in accord with the command of Section 446(b)* of

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*26 U.S.C.A. §446, which provides in pertinent part as follows:

"(a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

the Internal Revenue Code. Required use of an accrual method of accounting is not a dispensation from the fundamental precept that the accounting clearly reflect that which by a present right to receipt is "earned", and is subject to the taxpayer's dominion and use, although a possibility of its future return may exist. A recent application of this doctrine is found in *Van Wagoner* v. *United States*, 5 Cir., 368 F. 2d 95. Moreover, taxpayer made no showing of its experience with respect to the return of prepaid interest. It did not demonstrate that any significant amount was actually refunded. In this respect the taxpayer's proposed treatment of the item, with which the District Court agreed, appears to be as artificial as the bases for deferral relied upon and rejected in *Schlude* and *American Automobile Association*.

Taxpayer's reliance upon *Gunderson Bros. Engineering Corp.* v. *Commissioner*, 42 T.C. 419, and *Luhring Motor Co.* v. *Commissioner*, 42 T.C. 732, is misplaced. Those cases did not involve amounts actually received by the taxpayers by way of prepayment. *Beacon Publishing Co.* v. *Commissioner*, 10 Cir., 218 F. 2d 697, and *Schuessler* v. *Commissioner*, 5 Cir., 230 F. 2d 722, are distinguishable. See *American Automobile Association*, 367 U.S. 687, 691, footnote 4. Likewise, certiorari was granted in *American Automobile Association* in recognition of the conflict between *Bressner Radio, Inc.* v. *Commissioner*, 2 Cir., 267 F. 2d 520, and *American Automobile Association* v. *United States*, 149 Ct. Cl. 324, 181 F. Supp. 255, and the conflict was resolved against *Bressner*. Consequently, we are not persuaded by the decisions upon which taxpayer chiefly relies. Nor are we impressed by the support taxpayer attempts to glean from the dissent in *American Automobile Association*.

We conclude that the District Court's conclusion with respect to prepaid and capitalized policy loan interest was erroneous.

We have considered certain additional but subsidiary or peripheral contentions the taxpayer and amicus curiae have advanced in support of their position on appeal, but we are of the view that none of them merit an extension of this opinion for the purpose of discussing the same.

The judgment order of the District Court is reversed.

REVERSED.

APPENDIX B

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

Thursday, July 11, 1968

Before

Hon. LATHAM CASTLE, *Chief Judge,*
Hon. JOHN S. HASTINGS, *Circuit Judge,*
Hon. WIN G. KNOCH, *Senior Circuit Judge.*

THE FRANKLIN LIFE INSURANCE COMPANY,

Plaintiff-Appellee,

No. 16580 vs.

UNITED STATES OF AMERICA,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Illinois, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment order of the said District Court in this cause appealed from be, and the same is hereby, REVERSED, in accordance with the opinion of this Court filed this day.

APPENDIX C

Order on Petition for Rehearing

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

August 30, 1968

Before

Hon. LATHAM CASTLE, *Chief Judge,*
Hon. JOHN S. HASTINGS, *Circuit Judge,*
Hon. WIN G. KNOCH, *Senior Circuit Judge.*

THE FRANKLIN LIFE INSURANCE COMPANY,

Plaintiff-Appellee,

No. 16580 vs.

UNITED STATES OF AMERICA,

Defendant-Appellant.

On consideration of the petition for rehearing filed herein by The Franklin Life Insurance Company, plaintiff-appellee, and of the answer of the United States of America, defendant-appellant, to said petition:

IT IS ORDERED that the petition for rehearing is denied, and that the concluding portion (last two lines) of the opin-

ion filed and issued herein on July 11, 1968 be modified to read as follows:

> "The judgment order of the District Court is reversed and the cause is remanded to the District Court with directions to enter a judgment order consistent with this opinion.
>
> REVERSED AND REMANDED WITH DIRECTIONS."

AND IT IS FURTHER ORDERED that a judgment order of this Court be entered accordingly.

APPENDIX D

District Court Findings of Fact and Conclusions of Law

FINDINGS OF FACT

and

CONCLUSIONS OF LAW

The Court finds that certain basic information has been stipulated in a Basic Stipulation of Facts, (hereinafter referred to in the Court's findings as "Basic Stip."), filed herein on September 20, 1965; in a Supplemental Stipulation, (hereinafter referred to in the Court's findings as "Supp. Stip."), filed herein on November 15, 1966; and in a Second Supplemental Stipulation (hereinafter referred to in the Court's findings as "Second Supp. Stip."), filed herein on December 16, 1966. The abbreviations "T" and "Tr." refer to the transcript of oral testimony and proceedings at the trial, "JX" and "Joint Ex." refer to joint exhibits, "TX" and "Pltf. Ex." refer to Plaintiff's Exhibits, "DX" and "Deft. Ex." refer to Defendant's Exhibits, and "N.A.I.C." refers to the National Association of Insurance Commissioners.

The Court, in drafting its Findings of Fact and Conclusions of Law, has, because of the numerous and involved issues herein involved, proceeded in the same order and manner as did the trial of the action: with Preliminary Findings of Fact on the stipulated preliminary matter immediately followed by Preliminary Conclusion of Law, as well as Findings of Fact and Conclusions of Law

being separately stated with respect to each of the issues in the case.

(Tr. 198)

PRELIMINARY FINDINGS OF FACT

1. The plaintiff, The Franklin Life Insurance Company, is a life insurance corporation organized and existing under the laws of the State of Illinois with its Home Office and principal place of business in the City of Springfield, County of Sangamon and State of Illinois within the jurisdiction of this Court.

2. The plaintiff was, during the tax years here involved, engaged in the business of a life insurance company as defined in Sec. 801(a) of the Internal Revenue Code of 1954, which, as amended, is hereinafter referred to as "Code."

3. The taxable years at issue in this case are the taxpayer's calendar years 1958, 1959, 1960, 1961, and 1962, inclusive. In addition, although the year 1957 is not at issue, certain adjustments with respect to the year 1957 which were made by the Internal Revenue Service are pertinent in connection with this case, because those adjustments affect the taxpayer's 1959 tax liabilities, for the reasons outlined in Section 818(e)(3)(A) of the Internal Revenue Code of 1954. (Basic Stip., par. 2).

4. The plaintiff timely filed its United States Life Insurance Company Income Tax Returns, Forms 1120L, for the calendar years 1958 through 1962, inclusive, pursuant in each instance to timely extensions of time for filing; the date on which each return was filed and the total in-

come taxes as computed by the plaintiff on each return which total income taxes have been paid in full by the plaintiff are:

Year	*Date of Filing*	*Total Income Tax as Shown on Return*
1958	September 15, 1959	$2,806,154.45
1959	September 14, 1960	$3,173,654.03
1960	[redacted]	[redacted]
1961	September 14, 1962	$4,921,765.30
1962	June 17, 1963	$5,670,054.55

5. The Internal Revenue Service audited plaintiff's United States Life Insurance Company income tax returns for the calendar years 1958 through 1962, inclusive, and assessed the following tax deficiencies, together with interest thereon:

(Tr. 199)

Year	*Tax Deficiency*	*Interest*	*Total*
1958	$138,402.45	$41,238.24	$179,640.69
1959	$218,626.37	$48,127.42	$266,753.79
1960	$253,963.73	$45,194.94	$299,157.67
1961	$279,123.03	$32,925.05	$312,048.08
1962	$173,418.47	$10,051.14	$183,469.61

6. The amounts of deficiency tax and interest hereinabove set forth were paid by the plaintiff in full to the Internal Revenue Service on March 4, 1964, with the exception of a certain portion of the deficiency for 1959 income tax which is payable in ten equal installments in the amount of $2,179.64 each, and so made payable under the provisions of Sec. 818(e)(3)(A) of the Code; the first four

of the said payments of $2,179.64 each were paid in the payment made on March 4, 1964, with the remaining installments falling due in the tax years subsequent to those involved in this action.

7. The plaintiff timely filed, in accordance with the provisions of Sec. 6511 of the Code, the following twelve claims for refund with the Commissioner of Internal Revenue on Internal Revenue Form 843 with respect to the years 1958 through 1962, inclusive:

Year	*Date Claim Filed*	*Amount of Claim*
1958	July 29, 1964	$278,348.76
	August 3, 1964	2,069.12
	December 21, 1964	4,493.34
1959	July 29, 1964	439,998.46
	August 3, 1964	2,069.12
1960	June 11, 1964	236,766.40
	July 29, 1964	184,932.00
	August 3, 1964	2,069.12
1961	July 29, 1964	428,868.59
	August 3, 1964	2,069.12
1962	July 29, 1964	362,266.98
	August 3, 1964	2,069.12

(Tr. 200)

8. This action was timely commenced on February 8, 1965, within the period of limitations prescribed by Sec. 6532(a)(1) of the Code with the exception that the action, when filed, was premature with respect to the claim of the plaintiff filed with the Commissioner of Internal Revenue on December 21, 1964 for the sum of $4,493.34, which pre-

matureness is of no importance to this action as the parties have agreed to the disposition of this claim and have stipulated that its prematureness shall not constitute a bar to the disposition of the claim in accordance with the stipulation of the parties.

9. The Internal Revenue Service assessed interest in the amount of $41,238.24 on the tax deficiency assessed against the plaintiff for the year 1958 which is [illegible] ment erroneously covered a period of time prior to September 15, 1959 and thereby resulted in an overpayment of interest by the plaintiff in the sum of $4,152.07 (Para. 8 of Basic Stip.).

10. The plaintiff's claim for refund dated August 3, 1964, with respect to the calendar year 1958 (Joint Ex. 11), does not relate to any tax paid by the plaintiff with respect to the calendar year 1958. Accordingly, the plaintiff's claim for refund dated August 3, 1964, with respect to the calendar year 1958 was withdrawn, and no refund of tax or interest shall be made with respect to such claim for refund. (Basic Stip., par. 9).

11. In view of the Supreme Court's May 17, 1965 decision in *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233, the parties stipulated and agreed that, in computing the net taxable income of the taxpayer in this action, the congressionally prescribed formula—which is contained in Sections 804(a)(2) and 809(b)(1) of the Internal Revenue Code of 1954, as enacted by Section 2 of the Life Insurance Company Income Tax Act of 1959, supra, and which has the effect (1) of apportioning investment income from state

and municipal bonds pro rata between the untaxed policyholders' share of such income and the company's share, and (2) of limiting the tax deduction allowed under Section 103 of the Internal Revenue Code of 1954 to the pro rata portion of non-taxable state and municipal bond income allocated to the company's share of investment income—did not result in a tax on state or municipal bonds, or on income derived therefrom. The parties further stipulated and agreed that use of the congressionally prescribed formula described in the previous sentence does not entitle the taxpayer to make the adjustments described in Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954, as enacted by the Life Insurance Company Income

(Tr. 201)

Tax Act of 1959. The purpose of this paragraph of these findings is to dispose of the so-called "Atlas Issue" in this case in accordance with the Supreme Court's decision in *United States* v. *Atlas Life Insurance Co., supra.* Accordingly, the claims made in the following paragraphs of the Complaint in this action with respect to the Atlas case were withdrawn: Paragraph 4 of Count I, Paragraph 4 of Count II, Paragraph 4 of Count IV, Paragraph 4 of Count VII, and Paragraph 4 of Count IX. (Basic Stip., par. 10).

12. Unamortized premiums on mortgages are included by the plaintiff in its statement of assets as reflected in the total amount of its mortgages appearing on Line 3 of Page 2 of the Plaintiff's Annual Statements (JX 23 through 27). On Line 3.1 of Page 14 of said Annual Statements of the plaintiff is a statement of the mortgages and loans of the plaintiff and the unamortized portion of the premiums

on the mortgages is shown in Column 2 thereof as a non-ledger asset; the Internal Revenue Service, in making its deficiency assessments against the plaintiff for the year 1959 through 1962, inclusively, mistakenly included the amount of unamortized premiums as it appears on Page 14 of the Annual Statement for each of said taxable years with the result of a double inclusion of the unamortized premiums on mortgages in the statement of assets of the plaintiff which [redacted] amounts indicated below:

Year	*Amount*
1959	$ 42,387.60
1960	179,209.65
1961	267,228.03
1962	262,692.03

As a result of the double inclusion of the unamortized premiums on mortgages in the statement of assets of the plaintiff, a portion of the deficiency assessment, together with interest thereof, for the years 1959 through 1962 which was paid by the plaintiff on March 4, 1964, constitutes an overpayment by the plaintiff which it is entitled to recover (Para. 6 of Supp. Stip.)

(Tr. 202)

13. That plaintiff's experience with disposition of resisted claims reflects that it pays an average of 35.46% of the amount of resisted claims at the end of each year and the parties hereto have agreed by the Second Supplemental Stipulation filed herein that for the years 1958 through 1962 the plaintiff is entitled to a deduction in the amount of 35% of the increase in resisted claims over the

prior taxable year and that in any of the tax years here involved in which there was a decrease in the amount of resisted claims over the prior taxable year, 35% of the amount of such decrease shall constitute an offset against other deductions of the plaintiff relating to death claims.

14. The parties hereto have agreed by the Second Stipulation of Facts filed herein that the plaintiff is not entitled to a deduction for its investment expenses attributable to its investment income from tax exempt state and municipal bonds and that a reasonable method of determining Plaintiff's investment expenses attributable to income from tax exempt state and municipal bonds is by a ratio based upon the percentage of gross investment income of the plaintiff as it relates to its tax exempt income from state and municipal bonds and applying the ratio to the total investment expenses of the plaintiff.

15. That the agreement of the parties to settle the two issues as hereinabove reflected in Findings of Fact 11 and 12 relates only to the years 1958 through 1962, inclusive, and is not binding upon either party with respect to tax years subsequent to the year 1962.

16. The exact amount of refund due the plaintiff in this action, together with interest according to law, will be ascertained after the filing of the Court's Findings of Fact and Conclusions of Law on the basis of a recomputation by the Internal Revenue Service agreed to by both the plaintiff and the defendant which computation shall be made within a reasonable period of time and in the event the parties are unable to agree on such recomputation, they shall submit their dispute to the Court.

PRELIMINARY CONCLUSIONS OF LAW

1. That both the plaintiff and the defendant are properly before the Court and the Court has jurisdiction of the parties and of the subject matter of this action.

2. That both parties have been correctly designated and there is no misjoinder or nonjoinder of parties.

(Tr. 203) [redacted]

3. That the plaintiff, with respect to its Claim for Refund dated December 21, 1964, in the sum of $4,493.34 has made an overpayment of the sum of $4,152.07 which overpayment, together with interest thereon, will be taken into account in the computation to determine the amount of judgment to be entered herein.

4. That the plaintiff has been improperly assessed by reason of the double inclusion of unamortized premiums on mortgages in its assets for the years 1959 through 1962, inclusively, and the sum of the deficiency assessments, together with interest thereon, made against the plaintiff by the Internal Revenue Service for the years 1959 through 1962, inclusive, which is attributable to the double inclusion of unamortized premiums on mortgages in the assets of the plaintiff constitutes an overpayment of taxes and interest thereon by the plaintiff which overpayment will be taken into account in the computation to determine the amount of judgment to be entered herein.

5. That the plaintiff is entitled to a deduction in the amount of 35% of the amount of increase in resisted claims at the end of each tax year here involved over the next pre-

ceding year, and for the tax years here involved in which there was a decrease in the amount of resisted claims over the prior tax year, 35% of the amount of such decrease shall constitute an offset against other deductions of the plaintiff relating to death claims and accordingly 35% of the amount of increase in resisted claims and 35% of the amount of decrease in resisted claims will be taken into account in the computation to determine the amount of judgment to be entered herein.

6. The plaintiff is not entitled to a deduction for its investment expenses attributable to its investment income from tax exempt state and municipal bonds and the amount of plaintiff's investment expenses attributable to income from tax exempt state and municipal bonds will be taken into account in the computation to determine the amount of judgment to be entered herein.

(Tr. 204)

THE PLAINTIFF'S METHOD OF ACCOUNTING IN PREPARING ITS INCOME TAX RETURNS FOR THE YEARS 1958 THROUGH 1962, INCLUSIVE

Findings of Fact

1. The National Association of Insurance Commissioners, hereinafter referred to as N.A.I.C., was organized in 1871 and is a national organization composed of officials of the various states who are charged with supervision of insurance companies and their operations; soon after its organization, the N.A.I.C. adopted a uniform annual statement form and life insurance companies have filed annual statements since that time on forms adopted by the N.A.I.C.;

instructions for the preparation of annual statement forms are also prepared and approved by the N.A.I.C.

2. The Director of Insurance of the State of Illinois furnished the plaintiff forms for the Annual Statements for the tax years here involved, together with instructions for the preparation of said forms.

3. The plaintiff prepared and filed its Annual Statements for the years 1958 through 1962 (JX 25 through 27, inclusive) with the Director of Insurance of the State of Illinois and with the insurance departments of each other state in the United States with the exception of the State of New York in which state the plaintiff does not conduct its life insurance business.

4. None of the states which received the Annual Statements of the plaintiff for the tax years here involved found fault with the plaintiff's method of accounting in the preparation of its Annual Statements.

5. The plaintiff was examined for the years 1958 through 1962 by teams of N.A.I.C. examiners from various insurance departments which examinations were extensive with respect to the financial condition of the plaintiff as the principal purpose of each examination was to determine the financial condition of the plaintiff and the accuracy of the plaintiff's Annual Statements for the years covered in said examinations; the examinations of the plaintiff for the tax years here involved reflected that plaintiff's Annual Statements were completed in the manner required for the purposes of annual statements approved by the N.A.I.C.

(Tr. 205)

6. The Annual Statements of the plaintiff for the tax years here involved, were prepared under the accrual method of accounting for purposes of annual statements approved by the N.A.I.C. in accordance with instructions of the N.A.I.C. furnished to the plaintiff prior to completion of said Annual Statements.

7. The plaintiff's method of accounting as reflected in its Annual Statements is the method of accounting regularly employed by the plaintiff in keeping its books and records which method of accounting is in accordance with the general accepted accounting principles applicable to the life insurance industry.

Conclusions of Law

1. That all computations used by the plaintiff in determining its income taxes for the years 1958 through 1962 were made under an accrual method of accounting in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

2. That the income tax returns filed by the plaintiff for the tax years here involved were computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

3. That the plaintiff's method of accounting in completion of its income tax returns for the tax years here involved is in compliance with Sections 818(a) and 446(a) of the Code.

I.

INCREASE IN LOADING ON DEFERRED AND UNCOLLECTED PREMIUMS AS INCOME

Findings of Fact

1. The plaintiff is a legal reserve life insurance company and under the state laws governing the plaintiff, reserves for life insurance policies are determined on the basis of the net annual valuation premium regardless of whether an insured pays premiums on an annual, semiannual, quarterly or monthly basis. (T. 83). Certain terms common to the life insurance industry have the following meanings:

(a) *Gross Annual Premium.* This is a consideration paid by the insured to the Company for coverage for a policy year which is twelve months from date of the issuance of the policy and each twelve-months period subsequent to its anniversary date. (T. 84).

(b) *Net Annual Valuation Premium.* This is the amount needed each policy year to pay all policy contract claims according to the mortality tables and assumed rates of interest used in determining the reserve required by Law. (T. 84).

(Tr. 206)

(c) *Loading on the Annual Gross Premium.* This is the difference between the gross annual premium and the net annual valuation premium. (T. 84).

(d) *Deferred and Uncollected Premiums.* These are reserve offsets and are equal to that portion of the annual

premium for the current policy year which has not been received by the Company in the current taxable year. (T. 85).

2. A deferred premium represents only that portion of the annual premium which has not been received in the current policy year and is not that portion of the premiums for the balance of the current policy year which the plaintiff hopes to collect from its policyholders.

3. The total amount of premiums for a policy payable on other than the annual basis exceeds the annual premium for such policy which may be illustrated by assuming that the annual premium for a policy issued on November 28 is $400 and the premium is to be payable on a quarterly basis. Each quarterly premium would be $105 and the aggregate of the four quarterly premiums would be $420 for the policy year. It may be further assumed that the annual net valuation premium for the policy is $360 and the remaining $40 of the gross annual premium would be loading. Under this illustration, one quarterly premium in the sum of $105 is paid on November 28 and at the end of the plaintiff's taxable year the gross deferred premium on this policy is 75% of the annual premium in the sum of $300 and not the sum of the quarterly premiums falling due in the subsequent taxable year in the sum of $315. Under this illustration, the net deferred premium is $270 and the loading on the deferred premium is $30. (T. 94-96).

(Tr. 207)

4. The policies of the plaintiff provide, as required by law, for a 31-day grace period for the payment of premiums when due during which period the policy is carried in full force and effect. If a premium is due in December

of the taxable year but is not paid by the insured during the month of December, the unpaid portion of the annual premium for the policy which was due in December becomes uncollected at the end of the taxable year. This may be illustrated by assuming an annual gross premium due on December 15 in the sum of $400 of which $360 is the annual net valuation premium and $40 is loading. At the end of the year, the plaintiff is required by law to set up a net annual valuation reserve of $360 regardless of whether the annual premium in the sum of $400 due on December 15 is paid in December. (T. 91).

5. The plaintiff does not have the legal right to collect premiums when they become due on its policies as premiums which have not actually been paid to the plaintiff are not contractually due from its policyholders. The provision for the payment of premiums does not afford a cause of action to the plaintiff to collect from its policyholder as the payment of premiums is at the sole election of an insured who may decide to keep his policy in force by such payment of premiums as they fall due or elect to abandon or otherwise permit his policy to lapse by non-payment of premiums. (T. 93).

6. The reserve liability of the Plaintiff, as required by law, is determined at the end of the calendar year and this item of reserve is shown on Line 1 of Page 3 of its Annual Statement as a liability. Included in this liability item are the deferred and uncollected net annual valuation premiums for which the plaintiff has not received an offsetting item of income. The method of accounting prescribed by the National Association of Insurance Commissioners provides for the offsetting of the deferred and

uncollected premiums by the inclusion of the deferred and uncollected premiums in the premium income of the plaintiff. Only net deferred and uncollected premiums are needed as offsets for the net annual valuation portion of the premiums included in reserves and the inclusion of the gross deferred and uncollected premiums overstates the premium income of the plaintiff. The Annual Statement required of the plaintiff provides a method of offsetting the overstatement of unreceived income.

7. The following is an illustration of the overstatement of unreceived income and the method of offsetting the amount of overstatement that is not necessary to offset the increase in reserves attributable to deferred and uncollected premiums.

(Tr. 208)

(a) On November 28, 1960, the plaintiff sells a policy on a quarterly basis providing for quarterly premiums of $105 each. The gross annual premium would be $400 and the annual valuation premium would be $360. At year end, the plaintiff must set up in its Annual Statement, a $360 reserve for this policy notwithstanding the fact that it has only received the sum of $105 and only $90 of which is the portion of the net annual valuation premium. This leaves a deferred and uncollected net annual valuation premium in the sum of $270. With respect to the $360 increase in reserves, the plaintiff has received the sum of $90 in cash which is insufficient to offset the reserve liability and the plaintiff must show another $270 item in order to fully offset the reserve for the policy sold in 1960.

(b) The annual report form of the plaintiff requires the inclusion of $300, the gross deferred and uncollected premium, as premium income together with the $105 actually received for the policy.

(c) The plaintiff, through the employment of this method of accounting, has overstated its income by $300 which is $30 more than the required $270 offset for the liability required by law.

(d) The Annual Statement of the plaintiff recognizes that there would remain an overstatement without some provision of an offsetting figure therefor, and next provides for a method of further offsetting the $30 overstatement so that the plaintiff will have only included in its summary of operations the actual premiums received together with the portion necessary to offset the increase in reserve attributable to deferred and uncollected premiums. (T. 94-97).

8. The actual method of offsetting the overstatement of deferred and uncollected premiums is shown by reference to the Annual Statement of the plaintiff for the years 1959 (JX 24) and 1960 (JX 25) and is illustrated as follows:

(a) At the end of 1959, the reserves of the plaintiff were, in round figures, $389,000,000 which is reflected in Line 1 on Page 3 of the Annual Statement. (T. 124).

(b) Of the foregoing amount, the net deferred and uncollected premiums of the plaintiff were, in round figures, $18,200,000 which is reflected on Line 17 of Page 2 of the Annual Statement. (T. 125).

(c) At the end of 1960, the reserves of the plaintiff amounted to $425,000,000 which is reflected on Line 1 of Page 3 of the Annual Statement for 1960. (T. 125).

(d) Of the foregoing sum, $20,000,000 is the net amount of deferred and uncollected premiums and this item appears on Line 17 of Page 2 of the Annual Statement for 1960. (T. 126).

(Tr. 209)

(e) The increase in reserves in the sum of $36,000,000 is reflected on Line 17 of Page 4 of the Annual Statement for 1960. (T. 126).

(f) On Line 1 of Page 4 of the Annual Statement for 1960 appears premium income of $98,000,000 representing premiums received together with gross deferred and uncollected premiums which were not received. (T. 131, 136).

(g) The foregoing $98,000,000 figure is composed of the entries made in Exhibit 1 appearing on Page 7, Column 1 which shows the composition of the $98,000,000 figure. (T. 135).

(h) The reserve figure on Line 17 of Page 4 of the Annual Statement for 1960 in the sum of $36,000,000 represents the increase over the prior year. Of this $36,000,000, $1,800,000 is the increase in reserves attributable to deferred and uncollected premiums which have not been received by the plaintiff in 1960. The gross amount of the deferred and uncollected premiums has increased by $2,165,000 which figure is included in the $98,000,000 figure on Line 1 of Page 4. Thus, the increase in deferred and uncollected

premiums of the plaintiff is overstated by $365,000 ($2,165,000-$1,800,000) which sum is not necessary to offset the increase in reserve and accordingly, Line 25 of Page 4 of the Annual Statement provides for the offsetting of the $365,000 figure. (T. 131-134).

9. That the $365,000 figure in the foregoing example does not constitute taxable income to the plaintiff for the year 1960. (T. 137).

10. Deferred and uncollected premiums are included as accrued income for the sole purpose of offsetting the part of unreceived net premiums required in reserve calculation. The method of accounting prescribed by the National Association of Insurance Commissioners for the plaintiff in providing for an offset for the increase in reserves of the plaintiff provides for the inclusion of the gross deferred and uncollected premiums less the increase in loading thereon with the effect of including in gross income only that portion of the deferred and uncollected premiums necessary to offset the increase in reserves attributable to deferred and uncollected premiums. (T. 137).

(Tr. 210)

11. To include the increase in loading on deferred and uncollected premiums in the income of the plaintiff for any taxable year would constitute an overstatement of the income of the plaintiff by that amount for each of the taxable years and would be an improper inclusion of an item in income which the plaintiff has no right to receive. (T. 258, 544).

12. Under the method of accounting prescribed for the plaintiff by the National Association of Insurance Commissioners, the plaintiff has, in each of the taxable years here involved, included in its premium income only the amount of the net annual valuation deferred and uncollected premiums necessary to offset a corresponding increase in reserves attributable to deferred and uncollected premiums which has been done through the method of accounting so prescribed for the plaintiff. This method provides a corresponding offset for such increase in reserves. The inclusion of the increase in loading is unnecessary to accomplish this purpose and to otherwise include it in the premium income of the plaintiff would subject the plaintiff to income tax on items it has no right to receive. (T. 137-139).

13. The method of accounting prescribed for the plaintiff by the National Association of Insurance Commissioners and used by it in the tax years involved by which method the plaintiff includes in its premium income the gross deferred and uncollected premiums and deducts therefrom the increase in loading thereon provides only the amount of net annual valuation premiums in income as are necessary to offset the increase in reserves attributable thereto and is the proper method of reporting premium income for the plaintiff for the years here involved. (T. 137).

Conclusions of Law

1. That the method of accounting of the plaintiff in the preparation of its income tax returns for the years 1958 through 1962 inclusive was under an accrual method of accounting in accordance with the provisions of Sec. 818(a) of the Internal Revenue Code of 1954 and was also under

an accrual method of accounting as the same is contemplated by Sec. 451 of the Internal Revenue Code of 1954.

(Tr. 211)

2. That the deduction for increase in loading on deferred and uncollected premiums is not a deduction for anticipated future expenses but is merely an offset to avoid the overstatement of the premium income of the plaintiff in each of the taxable years. The plaintiff in determining its gain from operations should include only the amount of deferred and uncollected premiums necessary to offset the amount of increase in reserves incurred by reason of deferred and uncollected premiums and the inclusion of the increase in loading on the deferred and uncollected premiums constitutes an overstatement of the income of the plaintiff by that amount which is erroneous and should be excluded in determining the plaintiff's gain from operations in each of the tax years here involved.

3. That the method of accounting adopted by the plaintiff for the years 1958 through 1962 inclusive, clearly reflected its income and the inclusion of the increase in loading on the deferred and uncollected premiums in the tax years here involved constituted an overstatement of the gain from operations of the plaintiff and the consequential tax assessment thereon was unlawful.

4. That the plaintiff with respect to the deficiency assessments paid by it on March 4, 1964, shall have judgment for that portion of said deficiency assessments, with interest thereon from date paid, which is represented by the deficiencies determined by the Commissioner of Internal Revenue in contravention of the foregoing findings of fact and conclusions of law.

II.

LOADING ON DEFERRED AND UNCOLLECTED PREMIUMS AS ASSETS

Findings of Fact

1. The findings of fact of this Court respecting the issue of increase in load on deferred and uncollected premiums are applicable to this issue and are so found by this Court to be facts.

2. The plaintiff as required by law in making its Annual Statement for the end of each taxable year, computed its life insurance reserves on the assumption that on each policy anniversary the full annual premium has been received and in calculating such reserves, the full annual net valuation premium was used. (T. 83, 106).

3. The net annual valuation portion of the gross deferred and uncollected premiums is included in the life insurance reserves on the policies of the plaintiff. (T. 85).

(Tr. 212)

4. The plaintiff does not have a corresponding asset for this reserve liability as it has no legal right to collect the deferred and uncollected premiums, however the method of accounting prescribed by the National Association of Insurance Commissioners for the plaintiff provides for the offsetting of this portion of the reserve liability by an amount equal to the net annual valuation deferred and uncollected premiums which have not been received and this sum is entered as an asset of the plaintiff. This may be illustrated as follows:

(a) Reference is made to Pages 2 and 3 of the Annual Statement of the Plaintiff for 1960 (Joint Exhibit 25).

(b) On Line 1 of Page 3 which is the Statement of Liabilities of the plaintiff, there appears a reserve for life insurance policies in the sum of $425,000,000 (round figures). Of this sum, $20,000,000 (round figures) represents the portion of net annual valuation premiums not received during the taxable year and is deferred and uncollected. (T. 109).

(c) Although the plaintiff has no legal right to collect premiums covering the foregoing amount from its policyholders, it is permitted in its Annual Statement to set up an offsetting entry which appears on Line 17 on Page 2 of the Annual Statement in the form of an "asset" of $20,000,000 (round figures) on account of life insurance premiums deferred and uncollected. (T. 110).

(d) In arriving at the $20,000,000 asset figure, the plaintiff properly determined the gross amount of deferred and uncollected premiums and subtracted therefrom the loading thereon in order to determine the portion of the net annual valuation premiums to be used as an offset which offset is determined by the amount of reserve liability. (T. 104).

(e) In assessing the deficiency against the plaintiff, the Commissioner of Internal Revenue improperly asserted that Line 17 on Page 2 should have reflected the gross amount of deferred and uncollected premiums in the sum of $27,000,000 (round figures) which is the amount of the unpaid net annual valuation premiums used as an offset to the corresponding reserve plus loading thereon which ac-

tion by the Commissioner improperly increased the assets of the plaintiff by approximately $7,000,000. (T. 102).

(Tr. 213)

5. The plaintiff has no legal right to collect deferred and uncollected premiums and the inclusion of loading thereon in the statement of assets of the plaintiff would be an overstatement of the plaintiff's assets and a corresponding overstatement of the surplus of the plaintiff thereby distorting the financial statement of the plaintiff and would be improper. (T. 259, 543).

6. That in determining the assets of the plaintiff for calculation of its investment income, the loading on deferred and uncollected premiums is not to be considered an asset and inclusion of loading thereon in the assets of the plaintiff in the tax years here involved by the Commissioner of Internal Revenue was erroneous as only the net annual valuation portion of the deferred and uncollected premiums in an amount equal to the corresponding reserve liability constitutes assets of the plaintiff for purposes of determining the plaintiff's investment income.

Conclusions of Law

1. That the plaintiff properly followed the method of accounting prescribed for it by the National Association of Insurance Commissioners and its accounting was correctly made in accordance with the provisions of Sec. 818(a) of the Internal Revenue Code of 1954.

2. That the loading on deferred and uncollected premiums does not constitute an asset of the plaintiff for the purposes of determining its taxable investment income and

the inclusion of such loading in the assets of the plaintiff by the Commissioner of Internal Revenue in assessing deficiencies against the plaintiff for the tax years here involved was unlawful.

3. That the plaintiff, with respect to the deficiency assessments paid by it on March 4, 1964, is entitled to judgment for that portion of said deficiency assessments with interest thereon from date paid, which is represented by the deficiences determined by the Commissioner of Internal Revenue contravention of the foregoing findings of fact and conclusions of law.

III.

UNEARNED INVESTMENT INCOME ARISING FROM LOANS TO POLICYHOLDERS

Findings of Fact

(Tr. 214)

1. The life insurance policies and annuity contracts issued by the plaintiff, which have cash values, provide that a loan may be obtained on the sole security of the policy at any time that a cash value is available and while the policy is in force. Interest on policy loans is payable in advance at the time the loan is made to the end of the current policy year and annually thereafter on the policy anniversary for the ensuing year. If the interest on the policy loan is not paid when due, it is added to the principal of the existing loan and bears interest at the same rate.

2. The whole or any part of the indebtedness arising from a policy loan may be repaid at any time. If repay-

ment of a policy loan is made during the policy year, the exact amount of interest ratably earned by the plaintiff is retained by it and the residue is returned to the policyholder. If the policyholder should surrender his policy for the cash value then only the exact amount of prepaid interest ratably earned by the plaintiff is retained by it and the residue is returned to the policyholder. If the policyholder should die then only the exact amount of prepaid interest ratably earned by the plaintiff is retained by it and the residue is paid to the beneficiary of the policy along with the principal sum of the policy. (T. 391, 394).

3. This may be illustrated by assuming a $100 cash loan upon a policy having an anniversary of July 1 with an interest provision of 5%. The 5% interest payable in advance amounting to $5.00 at the time the initial loan is made creates an indebtedness of $105 with the policyholder receiving $100 in cash. On December 31 of the year in which the loan is made, the loan has earned $2.50 which the plaintiff properly treats as earned income and the remaining $2.50 is unearned income which is reflected in Line 17 on Page 3 of its Annual Statement. Continuing with this illustrative case, on July 1 of the next succeeding year, there is due and payable the sum of $5.00 (round figures) as interest on the policy loan for the next policy year. If the policyholder pays the sum of $5.00 on the loan for this next year, it is received as unearned investment income and is so treated by the plaintiff. On December 31 of that year, the plaintiff has readily determined that it has earned $2.50 of the $5.00 which is included in its investment income and the remaining $2.50 is not so included in investment income but is treated as unearned investment income. (T. 388-391).

(Tr. 215)

4. The insured has the right to pay off a policy loan at any time and if he makes payment of the policy loan he will receive a refund of the unearned investment income held by the plaintiff with the plaintiff retaining only the portion of the interest income actually earned. Under the foregoing example, if the insured should repay the loan on August 1, the plaintiff would retain only 1/12th of the $5.00 interest received and refund the residue to the insured. The insured may surrender his policy for its cash value at any time and under this example, if the insured should surrender his policy on August 1, the plaintiff would retain only 1/12th of the prepaid interest and treat the same as earned income and refund the residue to the insured as part of the net cash value payable to him. If the insured, in this example should die on August 1, then the plaintiff would retain only 1/12th of the interest received in advance paying over the residue to the named beneficiary as part of the death benefits. (T. 391).

5. The method of determining what portion of the prepaid interest belongs to the plaintiff as earned interest at the end of the calendar year and the portion which is unearned interest is determined in accordance with established accounting principles (T. 405, 554); the amount of unearned interest at the end of the year which may become earned by the plaintiff is undeterminable and is dependent upon whether the insured continues to live or whether he elects to repay the loan or surrender the policy for its cash value.

6. The interest received by the plaintiff from its policyholders is for the use of money which shall be provided

by the plaintiff over a specified period of time and consequently the interest, when received by the plaintiff, does not unconditionally belong to the plaintiff.

7. The plaintiff had on hand commercial non-interest-bearing bank deposits at the end of each of the taxable years involved herein which were far in excess of the bank deposits needed by the plaintiff to cover existing escrow accounts and the amounts of prepaid but unearned investment income; the bank accounts of the plaintiff for the respective years and the amount of unearned investment income at the end of each respective year were:

Year	*Amount of Unearned Investment Income*	*Amount of Bank Deposits*
1958	$ 672,837.68	$11,763,337.74
1959	937,486.32	10,765,626.31
1960	1,231,454.33	11,650,430.00
1961	1,418,046.98	11,729,734.64

(Tr. 216)

8. When a policyholder fails to pay the interest on a policy loan when due, the plaintiff, if there is sufficient cash value, capitalizes the amount of interest and adds it to the principal of the existing loan which may be illustrated by assuming a policy anniversary of July 1 and a policy loan in the sum of $100 made on that date. On the following July 1, the policy anniversary, there is due the plaintiff the sum of $5.00 as interest on the policy loan for the next ensuing year and if the policyholder does not pay the $5.00 interest when due, the plaintiff will add the sum to the principal of the loan thereby increasing the indebtedness on the policy. On December 31 of that year, $2.50 of the unpaid capitalized interest has become earned interest and

is treated by the plaintiff as part of its investment income and the plaintiff properly treats the remaining $2.50 as unearned investment income. The $2.50 which has been earned constitutes an indebtedness of the policyholder which together with the original indebtedness of $100 makes an indebtedness of $102.50 which is the sum the plaintiff has properly treated as an asset in determining its taxable investment income under Phase I. (T. 406-409). Under this example, if the insured should repay the loan on August 1, the plaintiff would treat only 1/12th of the capitalized interest as earned income and part of the policy indebtedness and would disregard the remaining 11/12ths; the same is true if the policyholder surrenders the policy for its cash surrender value on August 1; the same is true if the policyholder should die on August 1. When interest has been capitalized and added to the principal of the loan, it is entirely dependent upon the future action of the policyholder as to how much of the interest will actually be earned by the plaintiff and thereby constitute the principal amount of the loan. As interest is earned ratably day by day, it ratably becomes an increase in the policy indebtedness. (T. 407).

9. The plaintiff, at the end of each taxable year, determined the portion of the unpaid but capitalized interest which was earned and treated the earned portion as part of its taxable investment income and in determining its assets for Phase I computations, properly treated the earned portion of the unpaid capitalized interest as part of the indebtedness due from its policyholders and as an asset of the plaintiff.

10. The plaintiff's method of accounting in each of the taxable years was an accrual method of accounting and all

of its computations were made in a manner consistent with the manner required for the purposes of annual statements approved by the National Association of Insurance Commissioners.

(Tr. 217)

11. The plaintiff in and by its method of accounting properly determined at the end of each taxable year the amount of prepaid interest which was earned by it and so reflected the same in its Annual Statement for each of said years and the amount of prepaid interest so earned by the plaintiff in each of the taxable years constitutes taxable investment income of the plaintiff for the respective years and was so treated by the plaintiff in the preparation of its income tax return for each of the taxable years.

12. The plaintiff properly excluded from its income tax return for each of the taxable years, the amount of prepaid interest which had not been earned by it and this excluded portion did not constitute income of the plaintiff in the year received.

13. The plaintiff determined at the end of each taxable year the amount of unpaid but capitalized interest on the policy loans which had been earned by it and properly treated the same as earned investment income. Only the amount of such capitalized interest as had been earned by the plaintiff at the end of each taxable year is an asset of the plaintiff for such year and was so treated by the plaintiff and that portion of capitalized interest which has not been earned during the taxable year does not constitute an asset of the plaintiff for the taxable year.

14. The adjusted basis of a policy loan is the amount actually due and owing from an insured.

15. The Commissioner of Internal Revenue, in assessing a deficiency against the plaintiff did, with respect to interest received by the plaintiff in advance, improperly include in the year of such receipt the amount of interest which was not earned by the plaintiff during the year of receipt.

16. The Commissioner of Internal Revenue, in making his deficiency assessment against the plaintiff, improperly included in the assets of the plaintiff at the end of each taxable year that portion of unpaid but capitalized interest on policy loans which was not earned by the plaintiff at the end of each taxable year.

Conclusions of Law

(Tr. 218)

1. That the method of accounting of the plaintiff in the preparation of its income tax returns for the years 1958 through 1962 inclusive, was on an accrual method of accounting in accordance with the provisions of Sec. 818(a) of the Code, on an accrual method of accounting as the same is contemplated in Sec. 451 of the Code and on the method of accounting on the basis of which the plaintiff regularly computes its income in keeping its books and in compliance with Sec. 446(a) of the Code.

2. That the taxable income of the plaintiff for the years 1958 through 1962 inclusive was computed under the method of accounting on the basis of which the plaintiff regularly computes its income in keeping its books.

3. That the method of accounting adopted by the plaintiff for the years 1958 through 1962 inclusive, clearly reflected its income and it was an abuse of the discretion of the Commissioner of Internal Revenue granted to him by Sec. 446(b) of the Internal Revenue Code of 1954:

(a) To include in the taxable income of the plaintiff in each of the taxable years that portion of unearned investment income represented by interest received on policy loans which had not been ratably earned by the plaintiff during the taxable year, and

(b) To include in the assets of the plaintiff at the end of each taxable year that portion of unpaid but capitalized interest on policy loans which had not been earned by the plaintiff at the end of each taxable year.

4. That the Commissioner of Internal Revenue improperly adopted a hybrid method of accounting for the plaintiff partially on an accrual method and partially upon a cash receipts and disbursements method in contravention of Sec. 818(a)(2) of the Internal Revenue Code of 1954 which enjoins the Commissioner from using the cash receipts and disbursements method for determining the taxable income of a life insurance company.

5. That the plaintiff, with respect to the deficiency assessments paid by it on March 4, 1964, is entitled to judgment for that portion of said deficiency assessments with interest thereon from date paid, which is represented by the deficiencies determined by the Commissioner of Internal Revenue in contravention of the foregoing findings of fact and conclusions of law.

[Portions of Findings and Conclusions dealing with unrelated issues omitted]

* * * * *

Dated at Springfield, Illinois, this 15th day of June, 1967.

OMER POOS, *Chief Judge,*
United States District Court.

APPENDIX E

Statutes and Regulations

1. The pertinent provisions of the Life Insurance Company Tax Act of 1959 (Internal Revenue Code of 1954, Chapter 1, Subchapter L, Part I; Sections 801(a) and (b), 802, 804, 805(a), (b) and (c), 809, 810(a), (b) and (c), 811 and 818(a)) are as follows:

Subpart A—Definition; Tax Imposed

§ 801. **Definition of life insurance company**

(a) **Life insurance company defined.**—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) **Life insurance reserves defined.**—

(1) **In general.**—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) **Reserves must be required by law.**—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c) (9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

(3) **Assessment companies.**—In the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

(A) sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and

(B) any funds maintained, under the charter or articles of incorporation or association (or by-laws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

For purposes of this part, the rate of interest assumed in calculating the reserves described in subparagraphs (A) and (B) shall be 3 percent.

(4) **Deficiency reserves excluded.**—The term "life insurance reserves" does not include deficiency reserves. For purposes of this subsection and subsection (c), the deficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

(A) the present value of the future net premiums required for such contract, exceeds

(B) the present value of the future actual premiums and consideration charged for such contract.

(5) **Amount of reserves.**—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

* * * * *

§ 802. **Tax imposed**

(a) **Tax imposed.—**

(1) **In general.**—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of a normal tax and surtax computed as provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11.

(2) **Alternative tax in case of capital gains.**—If for any taxable year beginning after December 31, 1961, the net long-term capital gain of any life insurance company exceeds the net short-term capital loss, then, in lieu of the tax imposed by paragraph (1), there is hereby imposed a tax (if such tax is less than the tax imposed by such paragraph) which shall consist of the sum of—

(A) a partial tax, computed as provided by paragraph (1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of such excess, and

(B) an amount equal to 25 percent of such excess.

(3) **Special rule for 1959 and 1960.**—If any amount is subtracted from the policyholders surplus account under section 815(c) (3) for a taxable year beginning in 1959 or 1960 on account of a distribution in 1959 or 1960 (not including any distribution treated under section 815(d) (2) (B) as made in 1959 or 1960), the tax imposed for such taxable year on the life insurance

company taxable income shall be the amount determined under paragraph (1) reduced by the following percentage of the amount by which the tax imposed by paragraph (1) is (without regard to this paragraph) increased, on account of the amount so subtracted, by reason of section 802(b) (3),--

(A) in the case of a taxable year beginning in 1959, 66⅔ percent; and

(B) in the case of a taxable year beginning in 1960, 33⅓ percent.

The preceding sentence shall not apply with respect to any payment treated as a distribution under section 815(d) (3).

(b) **Life insurance company taxable income defined.**--For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

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Subpart B—Investment Income

§ 804. Taxable investment income

(a) In general.—

(1) Exclusion of policyholders' share of investment yield.—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) Taxable investment income defined.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss plus the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)), computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

(3) **Partially tax-exempt interest.**—For purposes of this part, the deduction allowed by section 242 shall be an amount which bears the same ratio to the amount determined under such section without regard to this paragraph as (A) the normal tax rate for the taxable year prescribed by section 11, bears to (B) the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(4) **Small business deduction.**—For purposes of this part, the small business deduction is an amount equal to 10 percent of the investment yield for the taxable year. The deduction under this paragraph shall not exceed $25,000.

(5) **Application of section 246(b).**—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subsection, the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be 85 percent of the taxable investment income computed without regard to the deductions allowed by such sections.

(6) **Exception.**—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) **Gross investment income.**—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) **Interest, etc.**—The gross amount of income from—

(A) interest dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) **Short-term capital gain.**—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) **Trade or business income.**—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) **Investment yield defined.**—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) **Investment expenses.**—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses,

the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b) (4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b) (4)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) **Real estate expenses.**—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) **Depreciation.**—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) **Depletion.**—The deduction allowed by section 611 (relating to depletion).

(5) **Trade or business deductions.**—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

(A) There shall be excluded losses—

(i) from (or considered as from) sales or exchanges of capital assets,

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

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§ 805. **Policy and other contract liability requirements**

(a) **In general.**—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) **Adjusted reserves rate and earnings rates.**—

(1) **Adjusted reserves rate.**—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) **Current earnings rate.**—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) **Average earnings rate.**—

(A) **In general.**—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) **Special rules.**—For purposes of subparagraph (A)—

(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) and section 381(c) (22) applied to such taxable year, and

(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

(4) **Assets.**—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value

on December 31, 1958), of such asset for purposes of determining gain on sale or other disposition.

(c) **Adjusted life insurance reserves.**—

(1) **Adjusted life insurance reserves defined.**—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rate.

(2) **Average interest rate assumed.**—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

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Subpart C—Gain and Loss From Operations

§ 809. **In general**

(a) **Exclusion of share of investment yield set aside for policyholders.—**

(1) **Amount.**—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) **Required interest.**—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) **Gain and loss from operations.—**

(1) **Gain from operations defined.**—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax exempt interest, partially tax exempt interest, and dividends received);

(B) the amount (if any) by which the net long term capital gain exceeds the net short term capital loss; and

(C) the sum of the items referred to in subsection (c).

(2) **Loss from operations defined.**—For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax exempt interest, partially tax exempt interest, and dividends received);

(B) the amount (if any) by which the net long term capital gain exceeds the net short term capital loss; and

(C) the sum of the items referred to in subsection (c).

(3) **Life insurance company's share.**—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a) (1), equals 100 percent.

(4) **Exception.**—If it is established in any case that the application of the definition of gain from oper-

ations contained in paragraph (1) results in the imposition of tax on

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) **Gross amount.**—For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) **Premiums.**—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) **Decreases in certain reserves.**—Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) **Other amounts.**—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) **Deductions.**—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(1) **Death benefits, etc.**—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) **Increases in certain reserves.**—The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) **Dividends to policyholders.**—The deduction for dividends to policyholders (determined under section 811(b)).

(4) **Operations loss deduction.**—The operations loss deduction (determined under section 812).

(5) **Certain nonparticipating contracts.**—An amount equal to 10 percent of the increase for the taxable year

in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c) (1).

(6) **Certain accident and health insurance and group life insurance.**—An amount equal to 2 percent of the premiums for the taxable year attributable to accident and health insurance contracts (other than those to which paragraph (5) applies) and group life insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) **Assumption by another person of liabilities under insurance, etc., contracts.**—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) **Tax-exempt interest, dividends, etc.**—

(A) **Life insurance company's share.** Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a) (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

(B) **Application of section 246(b).**—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A) (iii), the limit on the aggregate amount of the deductions allowed by sections 243(a) (1), 244(a), and 245 shall be 85 percent of the gain from operations computed without regard to—

(i) the deductions provided by paragraphs (3), (5), and (6) of this subsection,

(ii) the operations loss deduction provided by section 812, and

(iii) the deductions allowed by sections 243(a) (1), 244(a), and 245,

but such limit shall not apply for any taxable year for which there is a loss from operations.

(9) **Investment expenses, etc.**—Investment expenses to the extent not allowed as a deduction under section 804(c) (1) in computing investment yield, and the amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income.

(10) **Small business deduction.**—A small business deduction in an amount equal to the amount determined under section 804(a) (4).

(11) **Certain mutualization distributions.** — The amount of distributions to shareholders made in 1958, 1959, 1960, 1961, and 1962 in acquisition of stock pursuant to a plan of mutualization adopted before January 1, 1958.

(12) **Other deductions.**—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

(e) **Modifications.**—The modifications referred to in subsection (d) (12) are as follows:

(1) **Interest.**—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c).

(2) **Bad debts.**—Section 166(c) (relating to reserve for bad debts) shall not apply.

(3) **Charitable, etc., contributions and gifts.**—In applying section 170—

(A) the limit on the total deductions under such section provided by the first sentence of section 170(b) (2) shall be 5 percent of the gain from operations computed without regard to—

(i) the deduction provided by section 170,

(ii) the deductions provided by paragraphs (3), (5), (6), and (8) of subsection (d), and

(iii) any operations loss carryback to the taxable year under section 812; and

(B) under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(b) (3) shall be applied.

(4) **Amortizable bond premium.**—Section 171 shall not apply.

(5) **Net operating loss deduction.**—The deduction for net operating losses provided in section 172 shall not be allowed.

(6) **Partially tax-exempt interest.**—The deduction for partially tax-exempt interest provided by section 242 shall not be allowed.

(7) **Dividends received.**—The deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

(f) **Limitations on certain deductions.**—

(1) **In general.**—The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

(B) the taxable investment income for the taxable year.

(2) **Application of limitation.**—The limitation provided by paragraph (1) shall apply first to the amount of the deduction under subsection (d) (3), then to the amount of the deduction under subsection (d) (6), and finally to the amount of the deduction under subsection (d) (5).

(g) **Limitations on deduction for certain mutualization distributions.**—

(1) **Deduction not to reduce taxable investment income.**—The amount of the deduction under subsection (d) (11) shall not exceed the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deduction (but after the application of subsection (f)), exceeds

(B) the taxable investment income for the taxable year.

(2) **Deduction not to reduce tax below 1957 law.**—The deduction under subsection (d) (11) for the taxable year shall be allowed only to the extent that such deduction (after the application of all other deductions provided by subsection (d)) does not reduce the amount of the tax imposed by section 802(a) (1) for such taxable year below the amount of tax which would have been imposed by section 802(a) as in effect for 1957, if this part, as in effect for 1957, applied for such taxable year.

(3) **Application of section 815.**—That portion of any distribution with respect to which a deduction is allowed under subsection (d) (11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distribution made in 1959, 1960, 1961, or 1962, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(c) (2) (B).

§ 810. **Rules for certain reserves**

(a) **Adjustment for decrease.**—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a) (1)), the excess shall be taken into account as a net decrease referred to in section 809(c) (2).

(b) **Adjustment for increase.**—If the sum of the items described in subsection (c) as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year

by reason of section 809(a) (1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d) (2).

(c) **Items taken into account.**—The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b)).

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c) (2).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(5) Premiums received in advance, and liabilities for premium deposit funds.

In applying this subsection, the same item shall be counted only once.

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§ 811. **Dividends to policyholders**

(a) **Dividends to policyholders defined.**—For purposes of this part, the term "dividends to policyholders" means

dividends and similar distributions to policyholders in their capacity as such. Such term does not include interest paid (as defined in section 805(e)).

(b) **Amount of deduction.**—

(1) **In general.**—Except as limited by section 809(f), the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders

(A) increased by the excess of (i) the amounts held at the end of the taxable year as reserves for dividends to policyholders (as defined in subsection (a)) payable during the year following the taxable year, over (ii) such amounts held at the end of the preceding taxable year, or

(B) decreased by the excess of (i) such amounts held at the end of the preceding taxable year, over (ii) such amounts held at the end of the taxable year.

For purposes of subparagraphs (A) and (B), there shall be included as amounts held at the end of any taxable year amounts set aside, before the 16th day of the third month of the year following such taxable year (or, in the case of a mutual savings bank subject to the tax imposed by section 594, before the 16th day of the fourth month of the year following such taxable year), for payment during the year following such taxable year.

(2) **Certain amounts to be treated as net decreases.**—If the amount determined under paragraph (1) (B) exceeds the dividends to policyholders paid during the

taxable year, the amount of such excess shall be a net decrease referred to in section 809(c) (2).

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Subpart E—Miscellaneous Provisions

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§ 818. Accounting provisions

(a) Method of accounting.—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

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2. **Sections 446(a), (b) and (c) and 451(a) of the Internal Revenue Code of 1954, are as follows:**

§ 446. **General rule for methods of accounting**

(a) **General rule.**—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) **Exceptions.**—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) **Permissible methods.**—Subject to the provisions of [redacted] income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

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§ 451. **General rule for taxable year of inclusion**

(a) **General rule.**—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

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3. **Sections 1.809-4 and 1.818-2 of the Treasury Regulations, in pertinent part, read as follows:**

§ 1.809-4 **Gross amount**

(a) **Items taken into account.** For purposes of determining gain or loss from operations under section 809(b) (1)

and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809 (a) (1) and paragraph (c) of § 1.809-2), and the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (such capital gains item is included in determining gain or loss from operations only for taxable years beginning after December 31, 1957). The additional three categories of items taken into account are:

(1) **Premiums.** (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a) (7) (ii) of

§ 1.809-5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a) (20)).

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend [redacted] refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c) (1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a) (7) (ii) of § 1.809-5 for the definition of assumption reinsurance.

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§ 1.818-2 **Accounting provisions**

(a) **Method of accounting.** (1) Section 818(a) (1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual

method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application of section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of items under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a) (2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a) (2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a) (2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (sec-

tion 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

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